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DIRECTORATE OF
INTELLIGENCE

Intelligence Memorandum

Cambodia: The War Economy in 1971 and Prospects for 1972

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CENTRAL INTELLIGENCE AGENCY
Directorate of Intelligence
March 1972

INTELLIGENCE MEMORANDUM

CAMBODIA: THE WAR ECONOMY IN 1971 AND PROSPECTS FOR 1972

Summary

1. Twenty-three months of crisis and war have left Cambodia's economy seriously weakened and dependent on foreign aid to maintain its viability. Production losses have been particularly heavy in agriculture and have dried up exports and created shortages in Phnom Penh.

2. In October 1971 the government adopted long-awaited economic reforms along lines recommended by the International Monetary Fund (IMF) last March. Toward year's end, monetary pressures had eased significantly for the first time since hostilities began. The money supply continued to increase but at a decreasing rate, while price increases slowed considerably -- the general index actually fell in both November and December. The current rice crop, although considerably smaller than last year's, will still yield a surplus. Imports of rice will probably not be necessary until the latter part of the year.

3. As the recent trade and exchange reforms begin to take hold, inflationary pressures should ease still more. Preliminary reports indicate that importers responded very favorably to the most recent adjustment in the exchange rate. If imports reach $100 million -- a reasonable prospect given the level of expected foreign aid -- most of the increase in money supply caused by the budget deficit would be offset, thus vastly improving the country's chances for bringing inflation under control. On balance, the economic outlook is moderately favorable.

Note: This memorandum was prepared by the Office of Economic Research.

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Discussion

State of the Economy

4. Cambodia's industrial production, probably less than half its prewar total in 1971, continues to be inhibited by a number of factors. Temporary plant shutdowns have resulted from a combination of raw material and fuel shortages and an inability to market output. Furthermore, the country lost the bulk of its skilled labor force when many Vietnamese were repatriated at the outset of hostilities. Manpower shortages caused by army recruitment have further hampered industrial production. However, only a few plants have actually suffered direct war damage – the oil refinery at Kompong Som being the most notable example.

5. The war's effects have been greatest in agriculture. Rubber production ceased in mid-1970 because of damaged processing facilities and enemy presence. Countrywide rice output for the 1970/71 crop year[1] was down about 30% from the previous year. Other crops presumably were similarly affected.

6. The food supply situation remained tight all year. In May and June panic-buying, triggered by sudden exchange depreciation and sharp increases in the price level, created temporary but serious rice shortages in Phnom Penh. Since then, however, hoarding has been a relatively minor problem. While the government was forced to ration relatively scarce commodities, such as rice, salt, sugar, and pork, throughout the year, private shops were usually well-stocked, and few instances of serious hardship were reported. Refugees continued to flow into the capital during the year. Yet, Phnom Penh managed to absorb them with so little apparent strain that it was year's end before a refugee "problem" actually became visible. Even now, reported instances of queuing, begging, or other signs of scarcity are relatively rare.

1971 Budget

7. Cambodia's financial position deteriorated during 1971.[2] The net budget deficit amounted to 10.8 billion riels, compared with the 6.6 billion originally projected (see the table). This overrun resulted largely from a lag in aid deliveries. Revenues showed some improvement during the year. Rates for a variety of import taxes were increased by the National Assembly in July. In addition, larger customs collections on a higher volume of imports

1. 1 June 1970 to 31 May 1971.
2. The Cambodian fiscal year coincides with the calendar year.

Cambodia: Government Budgets

Million Riels

	1971							Ministry of Finance Projected 1972 Budget	
	January-July		August-December						
	Actual	Rate per Month	Actual	Rate per Month	Actual	Original Budget	Actual as a Percent of Original Budget		
Total expenditures	*9,375*	*1,339*	*7,683*	*1,537*	*17,058*	*18,700*	91	*22,667* a/	
Civil	1,970	281	4,144	829	6,114	7,151	85		
Personnel	1,592	227	2,206	441	3,798	3,534	107	3,830	
Material	378	54	1,938	388	2,316	3,617	64		
Military	7,405	1,058	3,539	708	10,944	11,549	95		
Personnel	7,248	1,036	2,735	547	9,983	10,549	95	12,200 b/	
Material	157	22	804	161	961	1,000	96	5,600 c/	
Debt Service								1,037	
								Alternatives	
Total revenues	*2,054*	*293*	*2,471*	*494*	*4,525*	*6,237*	73	*12,293* d/	*8,130* e/
Customs duties	871	124	1,583	317	2,454	2,240	110	4,900	2,625
Direct and indirect taxes	999	143	756	151	1,755	3,119	56	6,742	4,854
Other	184	26	132	26	316	878	36	651	651
Total deficit	7,321		5,212		12,533	12,463		10,374	14,537
US aid counterpart					1,746	5,824		8,090	8,090
Net budget deficit					*10,787*	*6,639*		*2,284*	*6,447*

a. Excluding some 600 million riels that may be required to subsidize rice sales in the capital.
b. Including 100 million riels allocated for recruitment, 300 million riels for step promotions, and 1,300 million riels for the cost of living increase effected last October. It does not allow for additional cost of living increases that may become necessary in 1972.
c. Including projected civilian expenditures for material.
d. Based on $100 million in imports valued at an exchange rate of 140 riels per US $1.
e. Based on $75 million in imports valued at an exchange rate of 100 riels per US $1.

and the application of a higher exchange rate in calculating duties further boosted revenues in the last quarter. However, improvements in revenue collections were offset by an increasing rate of government spending. Savings expected from reductions in the civilian budget never materialized, primarily because of salary increases that were paid retroactively in July. Material expenditures, both civilian and military, increased markedly after restrictions were lifted in July.

Military Budget

8. The largest budgetary item has been the cost for military personnel. This item alone accounted for 59% of total government outlays in 1971 and, in absolute terms, represented a 153% increase over the previous year.

9. Since August, payroll costs have shown a remarkable decline for reasons that are not wholly apparent. Based on Ministry of Finance figures, military personnel expenditures fell from an average of 1,036 million riels per month during January-July to 547 million riels per month during August-December.

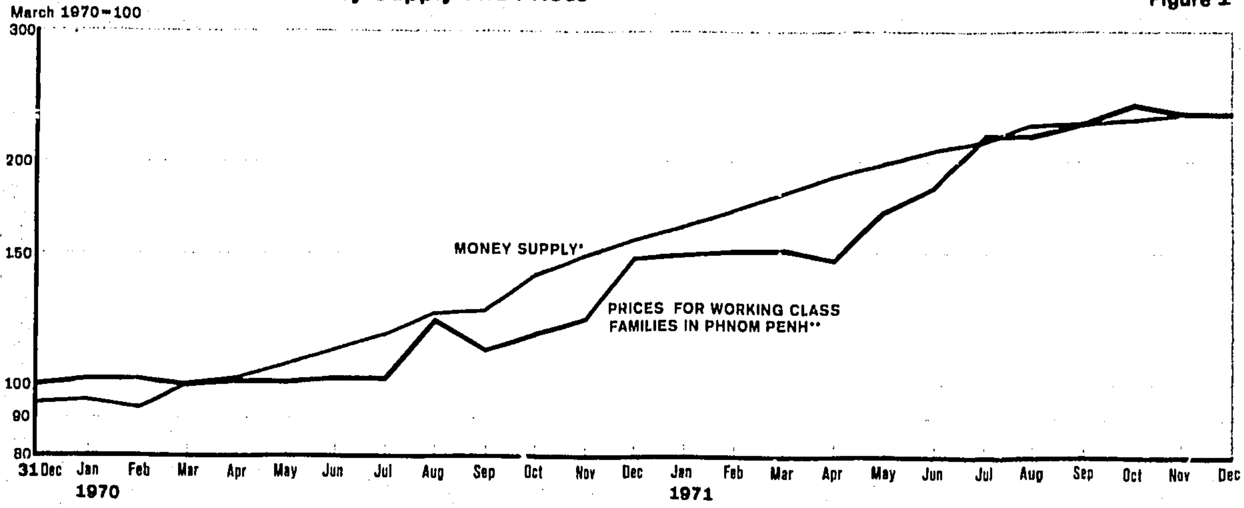
10. The decline partly reflects a drop in actual strength of the Cambodian army, owing to casualties, desertions, and recruitment problems, but most of the decline probably represents a deferment and not an actual fall in cash obligations. It would not be out of character for the government to have delayed salary payments to stay within the budget authorization for the year. In any case, it is unlikely that lower expenditures are the result of efforts to reduce the number of "phantom" soldiers – the endemic practice of payroll padding.

Money Supply

11. The money supply expanded about 55% during 1971, although the rate of increase declined toward year's end (see Figure 1). The expansion was largely due to government borrowing from the Banque Nationale du Cambodge (BNC) to finance budget deficits. Government borrowing from the BNC was 9,362 million riels for the year, up 73% from 1970 (see Figure 2). In the latter part of the year, the government reduced such borrowing about 50% by financing some of the deficit through the sale of Treasury bonds. A sharp increase in bank credit during September-November, a factor that previously had had an insignificant monetary impact, also contributed to the expansion of the money supply. Credit increases were related in part to the payment of final deposits and customs duties on commodities shipped under the first tranche of US aid. The deflationary impact of US aid fell far short of expectations. Because

CAMBODIA: Indexes of Money Supply and Prices

Figure 1



*Excluding cash in the banks and small sums on the current account of the general treasury.

**As reported by the Cambodian National Institute of Statistics.

513236 2-72 CIA

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of delays in utilizing aid funds, the contribution to the budget from US counterpart funds totaled only 1,746 million riels for all of 1971, compared with the original budget estimate of 5,824 million riels.

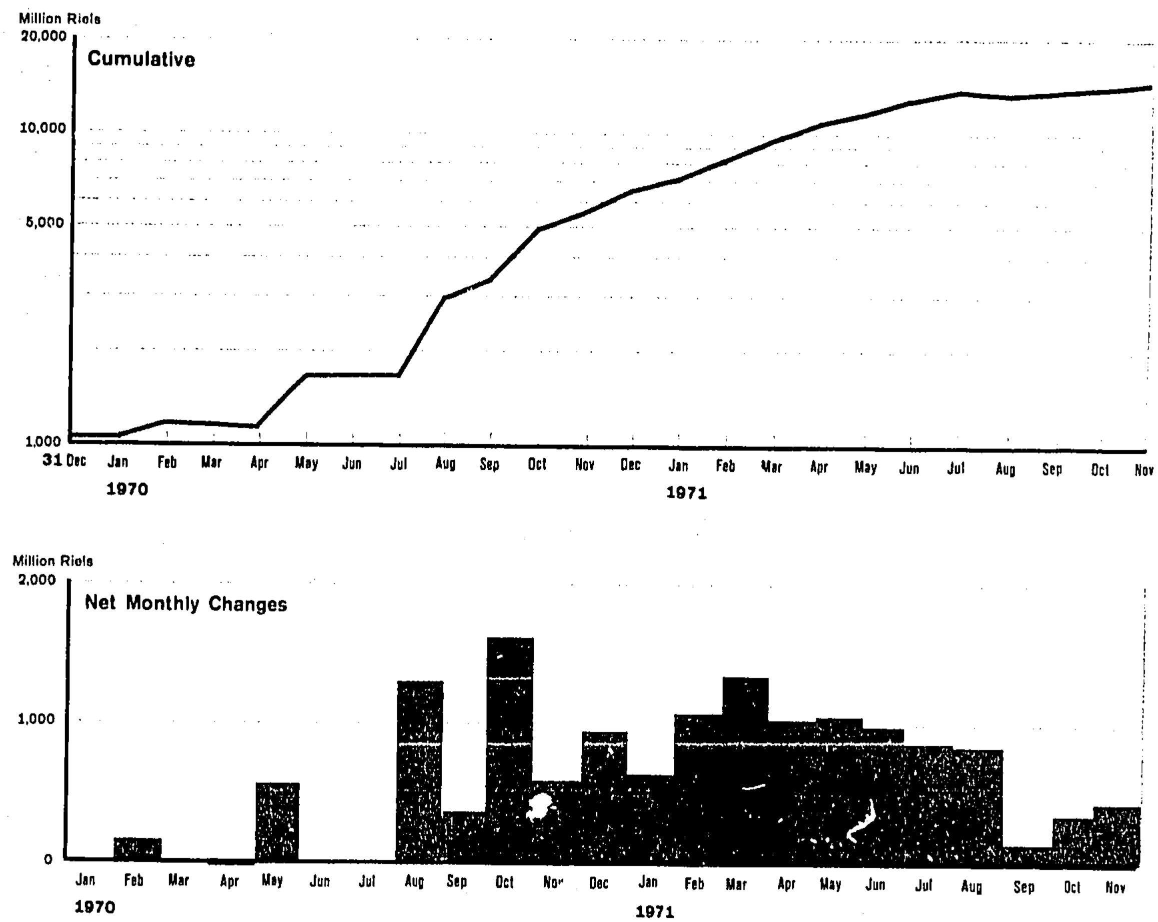
Prices

12. Inflation during 1971 came in spurts, reflecting seasonal and speculative factors and occasional transport disruptions, although its underlying cause was the large increase in the money supply. During the early part of the year, ample food supplies in the market following the harvest kept prices fairly stable. About mid-May, inflation accelerated in response to speculation concerning a poor harvest next season and a further depreciation of the riel. Although the price index decreased slightly in the last two months of 1971, its overall increase for the year was 60%.[3] The

3. The increase is understated because of the inclusion of a controlled price of rice in the index, whereas an increasingly larger portion of rice sales has been made at free market prices.

CAMBODIA: National Domestic Debt

Figure 2



513238 2-72 CIA

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following tabulation gives the price index for the Phnom Penh working class in 1971.

March 1970 = 100

Month	Index	Month	Index	Month	Index
January	150	May	171	September	235
February	151	June	185	October	244
March	151	July	218	November	239
April	148	August	216	December	238

Balance of Payments

13. Exports dropped sharply during 1971. According to the most recent Ministry of Commerce figures, exports were only $8.8 million for the first seven months of 1971, with South Vietnam taking 52%. The continued halt in rubber production, the lack of a corn surplus, and the suspension since June of rice and livestock shipments probably held export earnings for the year as a whole to $12 million or less. This compares with $39 million in 1970 and an average of about $75 million for the five prewar years.

14. Imports increased moderately. In the first seven months of 1971, imports were only $24.4 million, concentrated heavily on basic necessities, such as foodstuffs, petroleum, textiles, and pharmaceuticals. Total imports for 1971 are estimated at about $45 million,(4) somewhat higher than in 1970 but well below the average of $95 million for the five prewar years. Less than half of 1971 imports were US-financed, despite the fact that a $70 million Commodity Import Program (CIP) and $9.2 million in surplus agricultural commodities (PL 480) were earmarked for Cambodia for US FY 1971. The country was unprepared for a large-scale aid program and failed to take the necessary steps to expedite deliveries. The first tranche of the CIP – $20 million – was made on a reimbursable basis so that the Cambodians could use their own assets to place orders without delay. Government officials, however, were reluctant to commit reserves for commodities prior to their delivery. By the end of the year, deliveries under the $20 million reimbursable grant and the $9.2 million in PL 480 were about 50% complete. No deliveries were made on the $50 million balance of the CIP.

4. Import data compiled by the BNC are significantly higher than those of the Ministry of Commerce and Supply. The BNC estimates imports at $52.9 million in 1971, compared with $54.2 million in 1970.

15. Despite the government's efforts, the country's foreign exchange position steadily weakened during 1971. The government started the year with $60.2 million in reserves and received a $10 million deposit from the United States in November (part of a $20 million emergency cash grant). By the end of the year, gold and foreign exchange reserves were only $35.2 million (see Figure 3), including $7.8 million held in a blocked account.[5]

Economic Prospects for 1972

16. Cambodian economic performance in 1972 will depend largely on how well the current, relatively good crop is harvested and marketed, on the effectiveness of the government's pricing policy in stimulating increased planting for the next season, on the success of economic reforms introduced in late October, and ultimately on the course of the war. The reforms, designed to bring inflationary pressures under control, comprise wide-ranging measures affecting government pricing, fiscal and monetary policy, and the foreign exchange and trade system.

Industrial Production

17. Industrial output should nearly match last year's level, provided all principal towns now under government control remain so. The Kompong Som refinery will not resume operation; for other industries, ample supplies of raw materials will remove a serious production bottleneck.

Agricultural Production

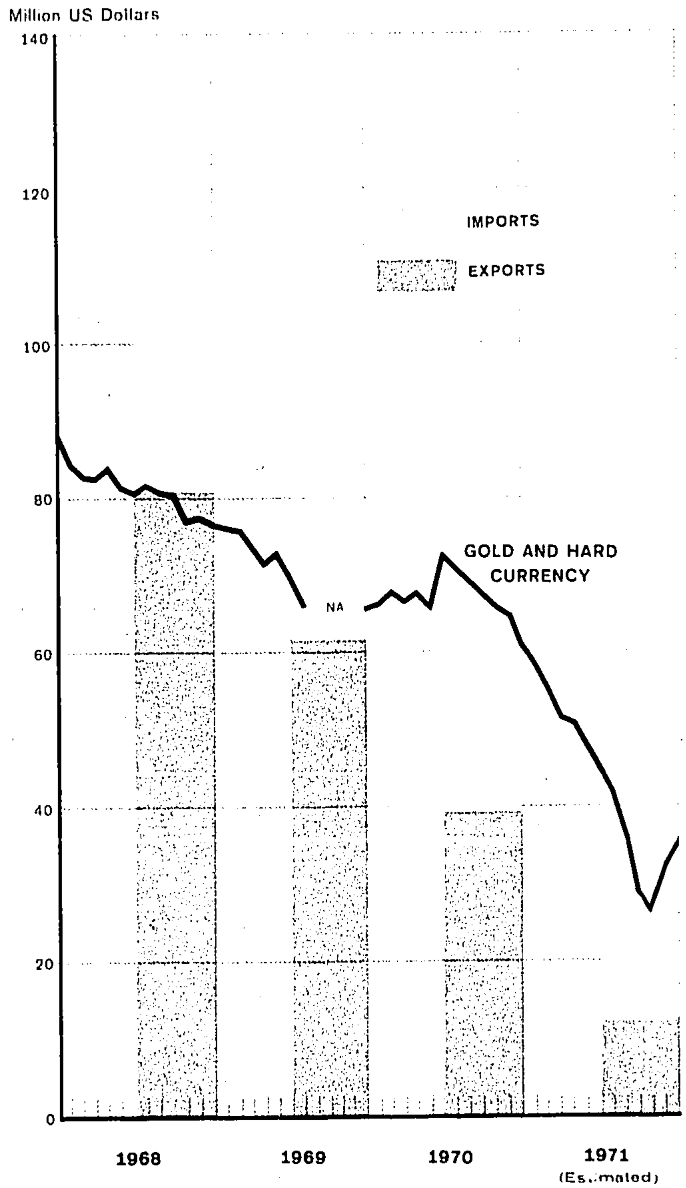
18. Farm output will fall substantially below last year's level because of a sharp drop in late-summer planting in the Northwest provinces. Production in other provinces, however, is expected to be about the same as last season. While there may be a small rice surplus, the situation will probably be tight toward the latter part of 1972, and rice imports could then be required. Some rubber from Cambodia's border plantations may be shipped to South Vietnam for processing, but there is little prospect for a sizable resumption of production and export.

19. Because of depressed farm prices, summer planting was off sharply – possibly by as much as 30% – in Battambang, normally the

5. The blocked account is in francs and represents the amount claimed by Cambodia against the assets of the Institute d'Emission, dissolved in 1954. They belonged to the former Associated French States of Indochina and have been on deposit with the Bank of France for more than 15 years. French officials have stated that funds will be automatically unblocked once agreement is reached between Laos, Cambodia, and South Vietnam on the disposition of assets. All attempts to do this up to now have failed.

Figure 3

CAMBODIA: Imports, Exports, and Gold and Hard Currency Holdings



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country's principal supplier of surplus agricultural commodities. Prices fell when road and rail interdictions and the risk of losses to enemy action caused rice dealers in the province to cut back purchases from farmers. A system of armed convoys organized in July to bring rice and other foodstuffs to Phnom Penh from the rich Northwest proved highly successful. Battambang paddy prices showed no appreciable increase, however, until September, too late to have had any marked effect on planting. Nevertheless, sizable surpluses are projected for some provinces, such as Prey Veng and Takeo. Preliminary official estimates for 13 provinces,[6] where some government presence exists, suggest an overall surplus of 20,000 tons.

20. In mid-January, declared rice stocks in the capital were at record lows, but these stocks did not include an undistributed gift of 20,000 tons of rice from Japan still in the hands of the Khmer Red Cross. Phnom Penh should be well supplied with rice for the near term, provided there is no repetition of large-scale hoarding that occurred last summer. The flow of newly harvested rice from all surplus areas, including the Northwest, to the capital should be fairly regular for the next few months. Typically, many farmers are forced to sell soon after the harvest because of debts incurred at planting time and/or inadequate storage facilities. Farmers in threatened areas will also want to sell their surplus rice early.

21. As part of its economic stabilization program, the government has taken steps to broaden incentives to farmers during the next planting season by setting a floor price for paddy. The support price may have been initiated in time to boost the annual dry-season crop in the Southeast above current estimates. This crop, which normally represents less than 10% of annual production, will be harvested in March. For political reasons, however, the government has not permitted the market to determine the retail price of rice. The government continues to control retail prices in the capital by drawing down its rice stockpile. Sorapa (the government procurement organization) is absorbing sizable losses on current purchases by having to sell at the low fixed price, but profits earlier in the year have so far precluded the necessity for subsidies.

1972 Budget

22. The government projects a 1972 budget deficit ranging between 10.4 billion and 14.5 billion riels, depending on the amount of revenue from both customs duties and indirect taxes on imports. This projection compares with an actual deficit of 12.5 billion riels in 1971. Expenditures budgeted for 1972 are 22.7 billion riels – 33% more than estimated actual

6. Excluded are the provinces of Kratie, Ratanakiri, Mondolkiri, Preah Vihear, Oddar Meanchey, and Stung Treng, which, taken together, constitute a rice-deficit area.

expenditures last year. The increase is almost entirely accounted for by an anticipated jump in military personnel costs and in civil and military expenditures for material, the latter reflecting, in part, larger planned outlays for road and bridge repair. Revenues are projected at between 8.1 billion and 12.3 billion riels, depending on assumptions about imports.

23. Recent stabilization measures, apart from eliminating subsidies for state enterprises, made little attempt to cut expenditures in any category. However, some tax increases have been instituted that should bring in additional revenue. The new tax measures have included raising ad valorem import duties by 50% on commodities previously subject to duties of greater than 35%. For other commodities, mostly necessities, duties were not increased. Import duties on salt and rice were suspended, and the duty on sugar was reduced from 60% to 10%. Higher excises on alcohol and tobacco have been enacted, along with a surtax on petroleum products, excepting gasoline and gas oil, since taxes on these items have proved too politically sensitive. In addition, a "tax to support the war," varying from 3% to 130%, will be levied on virtually all imports except spare parts.

Trade and Exchange Policy

24. An important element in holding the budget deficit within projected limits will be whether the new trade and exchange system can be made to function properly. Revision of the trade and exchange system along lines recommended by the International Monetary Fund was the key element in the government's stabilization package. The reforms eliminated most import restrictions and abandoned the official rate of 55 riels per US $1 in favor of what was intended to be a "flexible" rate. The greatly simplified import system now includes three commodity listings: one for which exchange is freely available, another for a limited number of goods that either are prohibited or require licenses, and a third for commodities eligible for import exclusively with CIP funds.

25. The performance of the newly liberalized exchange system has been disappointing thus far. Despite an extensive period when the import flow was sharply curtailed, no rush to place orders has taken place. CIP orders have also been particularly slow, despite an exclusive commodity list, more liberal downpayment provisions than for non-CIP imports, and a reduction in the portion of CIP funds tied to US procurement. According to a recent poll of local businessmen, the principal reason for lack of interest on the part of most importers has been an excessively high exchange rate. Officially, the exchange reforms were to provide for automatic adjustment of the exchange rate three times weekly to reflect, among other things, demand from importers, but the mechanism has never been allowed to operate. The exchange rate was arbitrarily changed only once in the last

two months of 1971, when it was moved from its initial position of 140 to 130 riels per US $1.

26. On 17 January, however, the government adopted still more measures aimed at eliciting a more favorable response from businessmen, and preliminary indications are that they are working. These measures included a reduction in indirect import taxes and establishment of a preferential exchange rate for goods tied to US procurement under CIP. The latter measure is designed to overcome the cost disadvantage of US goods, which now can be purchased at 90 riels per US $1. At the same time, the applicable rate for other imports has been changed from 130 to 120 riels per US $1. CIP orders rose sharply immediately after the new rate was put into effect. Moreover, BNC sales of free foreign exchange in the four days following the move to the 120 riels per US $1 rate amounted to $1 million, compared with total sales of $5.3 million in the previous three months of the new exchange system's operation.

Exchange Support Fund

27. A multilateral Exchange Support Fund for Cambodia now is assured. The fund will provide Cambodia with a source of hard currency for financing imports ineligible for financing under the CIP. Representatives of 12 countries attended the donor's conference in mid-January, with six making pledges totaling $19 million. The United States and Japan offered $12.5 million and $5 million, respectively, with Australia, Thailand, New Zealand, and Malaysia accounting for the remainder. In early February the United Kingdom joined the donor's club with a pledge of $0.5 million. Phnom Penh's own contribution brings the fund's initial capital to about $35 million. Italy, South Korea, and the Philippines sent representatives to the January meeting but postponed any decision on participation. The government hopes to get the fund into operation some time in March.